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SUBJECT: CHINA ANNOUNCES STIMULUS PLAN AHEAD OF G-20 SUMMIT

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¶1. (SBU) Summary: In advance of the G-20 summit China's leadership on Sunday took the unusual step of endorsing a long-anticipated stimulus package before its annual economic work conference later this month. The plan emphasizes infrastructure spending, but also includes targeted tax reductions, income support, and monetary easing. The announcement estimated the "stimulus package" will amount to RMB4 trillion (around USD600 billion or over 6+% of GDP) over the next two years, and RMB100 billion by the end of this year. Until more details are available it is impossible to determine how much of the announced spending is additional to what already would occurred. Tax cuts for business and monetary loosening are unlikely to spur investment given the deteriorating economic outlook and companies' excess capacity, and the continued high household precautionary savings. The government, however, appears committed to using fiscal spending to support the economy. Even if they maintain spending growth plans from previous years, it should still have a stimulatory impact on Chinese domestic demand and investment. End summary.

An Unusual Announcement

¶2. (SBU) China's State Council on Sunday released a statement announcing general principles that will guide its economic policies moving forward. The announcement, several weeks before the annual high level economic work conference, showed the leadership's concern about slowing economic growth and interest in getting a statement out before the upcoming G-20 summit. Business surveys showed rapidly deteriorating sentiment, and although the Chinese government has not released its October economic indicators, economists that have seen the data say they will show marked slowdowns in all areas of the economy.

¶3. (SBU) The announcement was short on details, like most State Council documents, but provides approval and guidance for the operational ministries to implement programs that fit within these guidelines. The ten approved areas (see Annex A) primarily emphasize infrastructure spending, but also include targeted tax reductions, income support, and looser monetary policy.

"Active" Fiscal "Easy" Monetary

¶4. (SBU) The State Council endorsed a "pro-active" fiscal policy for the first time since 1998-2004. The statement estimated the Chinese government will inject RMB 4 trillion into the economy: around RMB 100 billion worth of stimulus will occur this quarter, with the remainder operationalized in 2009 and 2010.

¶5. (SBU) Beijing will adopt a "moderately easy" monetary policy. In recent weeks the Central bank has lowered lending rates and reserve requirements, and removed loan quotas. Most observers expect additional rate cuts in the coming months.

Chinese Economists' Reactions

¶6. (SBU) Chinese economists without exception reacted positively to the announcement. Asia Development Bank chief economist Zhuang Jian and Development Research Council Macroeconomic Research Office Director Zhang Liqun hailed the stimulus package. Qinghua University Professor Yuan Gangming felt the measures would "effectively boost confidence" and were "released just in time," remarking positively on the wisdom of loosening monetary policy to support fiscal measures. This focus on consumer confidence was echoed by Beijing University professor Cai Zhizhou. Most Chinese economists are still calling for growth around 8 percent next year.

¶7. (SBU) Tax Research Institute Policy Research Office director Zhang Peisen and Chinese Academy of Social Sciences researcher Zhang Bin both emphasized the

importance of VAT reform to boosting domestic demand. Zhang Bin also praised the plan to build affordable housing, which would stimulate demand while helping ordinary people. However, Chairman of the Leading Group on Finance and Economics Liu He (who leads preparation of the annual work conference) had doubts that cutting the VAT for businesses (by rebating VAT paid on purchases of capital goods) would spur investment given overcapacity and the deteriorating outlook.

Bang or Whimper?

¶8. (SBU) The RMB2 trillion per annum should make up about 6-7% of estimated 2009-10 GDP. In the last two years, the central government's infrastructure spending accounted for about 3% of GDP, with local-level spending making up around 8% (or RMB3 trillion total, with roughly 40% of spending occurring in the 4th quarter).

¶9. (SBU) Absent additional details, it is impossible to discern how much of the announced spending is additional to what would have occurred. Based on conservative estimates of nominal GDP growth and the long-term trend of an increase in the ratio of government spending to GDP, overall government spending would have been expected to increase about RMB 2 trillion next year.

¶10. (SBU) However, much local infrastructure spending has been funded by property sales and state-controlled enterprises, so a slowdown in the property and corporate investment would have made it difficult to finance investments levels of recent years. Thus, part of the RMB 4 trillion could make up for shortfalls in local government investment.

¶11. (SBU) Given banks unwillingness to lend to small- and medium-sized enterprises due to increased credit risks, and large enterprises' lack of credit demand, due to excess capacity, looser monetary policy is not expected to boost domestic demand significantly in the short-term absent significant moral suasion on state banks and enterprises.

While the government has pressed state-owned banks to keep enterprises afloat during previous cyclical downturns, which led to a subsequent large accumulations of non-performing loans, bankers we have spoken with in the last several days (including CCB Chairman Guo, SDB President Newman, and GDB President Zink) note that the market-oriented corporate governance reforms since the last downturn will make moral suasion less effective, and the government appears to be focusing more on providing tax breaks and subsidies to borrowers.

Comment

¶12. (SBU) Premier Wen Jiabao noted during financial crisis that "confidence is more precious than gold" -- a large sentiment-boosting announcement in advance of the G-20 may be aimed at shoring up domestic sentiment.

¶13. (SBU) The Beijing leadership, however, is also committed to using government spending to stimulate the economy through infrastructure spending. In addition, even if the announced "stimulus" is largely a compilation of already planned spending increases, the government is committing to this in the context of a sharp fall in the growth of revenues (which rose only 10% year-on-year in the third quarter compared to 33% in 2007 and the first half of 2008). Given China's abundant savings, liquid banks and low government debt ratio, the central government is in a good position to use fiscal measures to contribute to domestic consumption and investment. Regarding timing, the government has already developed plans to improve transportation networks, build lower-income housing, and address China's water and pollution problems; many of these programs were delayed in the last couple of years while China focused on preparing for the Olympics, and Beijing could accelerate implementation without much trouble.

¶14. (SBU) However, until details of the recently announced

spending package are released, and particularly the full accounting of the mix of central government verses local and state-owned enterprise spending, and the amount of additional spending, it will remain impossible to determine the economic impact of the package.

Ten Areas for Fiscal Stimulus

¶15. (U) Annex A:

-- Housing: build more affordable and low-rent housing; speed slum clearance; expand a pilot program to rebuild rural housing; encourage nomad settlement.

-- Rural infrastructure: speed rural infrastructure construction; improve rural road and power grids; spread the use of methane; ensure drinking water safety; expedite the North-South water diversion project; reinforce at-risk reservoirs; strengthen large-scale irrigation; poverty relief projects.

-- Transportation: accelerate transport network expansion, including passenger rail links and coal routes; extend trunk railways; build airports in western areas; upgrade urban power grids.

-- Health and education: improve the local-level medical system; accelerate junior high school construction in rural western and central areas; build special education and cultural facilities.

-- Environment: enhance construction of sewage treatment and rubbish facilities; accelerate green belt and forest

planting programs; increase support for energy conservation and pollution-control projects.

-- Industry: support innovation, industrial restructuring, and the development of the high-tech and service industries.

-- Disaster rebuilding: speed reconstruction in the areas hit by the May 12 earthquake.

-- Incomes: raise next year's minimum grain purchase and farm subsidies; increase subsidies for low-income urban residents; increasing corporate pension funds and allowances.

-- Taxes: extending VAT reform to all industries (estimated impact will be to reduce corporate tax burden by RMB 120 billion, USD17.6 billion); encourage technological upgrading.

-- Finance: remove loan quotas; appropriately expand bank credit for priority projects, rural spending, smaller enterprises, technical innovations and industrial rationalization.

Measures Adopted to Date

¶16. (U) Annex B:

-- Raised tax rebates by 2% for certain textile and garment exports. (August 1)

-- Raised the credit quota by 5 percent for national commercial banks and 10 percent for local commercial banks. (August 5)

-- Cut interest rates for one-year loans by 27bps to 7.2%. (September 16)

-- Cut the reserve requirement ratio for all but the five largest banks by 1% to 16.5%. (September 25)

-- Removed the stamp tax on stock purchases; allowed SOEs to repurchase stocks; and began purchasing bank stocks. (September 19)

-- Launched a margin financing and securities lending plan. (October 5)

-- Allowed non-financial enterprises to float mid-term bonds. (October 6)

-- Cut deposit and lending rates 27bps. (October 8)

-- Cut the reserve-requirement ratio 0.5%. (October 15)

-- Increased house-purchase tax exemptions, lowered mortgage interest rates, and lowered down payment requirements. (October 27)

-- Cut benchmark interest rates by 27bps. (October 30)

-- Raised tax rebates for labor-intensive export items such as textiles, toys, garments, and high-tech products. (November 1)

RANDT